

# CONSOLIDATED FINANCIAL STATEMENTS

PREMERA

For the Years Ended December 31, 2002 and 2001  
with Report of Independent Auditors

# PREMERA

## Consolidated Financial Statements

Years Ended December 31, 2002 and 2001

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## Report of Independent Auditors

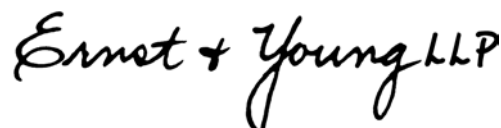
The Board of Directors  
PREMERA

We have audited the accompanying consolidated balance sheets of PREMERA (the Company) as of December 31, 2002 and 2001, and the related consolidated statements of income, comprehensive income, net worth, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of PREMERA as of December 31, 2002 and 2001, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

February 21, 2003



# PREMERA

## Consolidated Balance Sheets (In Thousands)

	December 31	
	2002	2001
<b>Assets</b>		
Cash and cash equivalents	\$ 34,630	\$ 73,498
Available-for-sale investments, at fair value:		
Fixed income securities	614,841	490,276
Marketable equity securities	61,327	125,880
Other investments	14,844	11,621
Total investments	691,012	627,777
Accounts receivable, net of allowance for doubtful accounts of \$9,488 in 2002 and \$17,393 in 2001	147,111	150,984
Investment income receivable	6,529	5,960
Federal income tax receivable	377	204
Physicians' deferred compensation plan assets	10,632	11,824
Prepaid expenses and deferred charges	30,849	5,628
Deferred federal income taxes, net	12,944	13,819
Property and equipment, net	68,777	57,969
Total assets	<u>\$1,002,861</u>	<u>\$947,663</u>

	<b>December 31</b>	
	<b>2002</b>	<b>2001</b>
<hr/>		
<b>Liabilities and net worth</b>		
Liabilities:		
Claims liability	<b>\$ 365,400</b>	\$355,715
Policy reserves	<b>25,122</b>	16,567
Unearned revenue	<b>59,609</b>	56,310
Accounts payable	<b>79,967</b>	83,012
Physicians' deferred compensation plan payable	<b>10,632</b>	11,824
Other liabilities	<b>73,199</b>	72,317
Total liabilities	<b>613,929</b>	595,745
Commitments and contingencies		
Net worth:		
General reserves	<b>371,802</b>	353,884
Accumulated other comprehensive income (loss)	<b>17,130</b>	(1,966)
	<b>388,932</b>	351,918
Total liabilities and net worth	<b>\$1,002,861</b>	\$947,663
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*See accompanying notes.*

# PREMERA

## Consolidated Statements of Income (In Thousands)

	<b>Year Ended December 31</b>	
	<b>2002</b>	<b>2001</b>
Revenue:		
Premiums	<b>\$2,556,841</b>	\$2,375,460
Administrative fees	<b>52,421</b>	44,481
Other income	<b>8,486</b>	6,868
Net investment income	<b>30,540</b>	31,490
Net realized gains (losses) on investments	<b>(35,067)</b>	7,515
	<b>2,613,221</b>	2,465,814
Expenses:		
Benefit expense	<b>2,149,927</b>	2,006,677
General and administrative	<b>328,789</b>	296,954
Commission and brokerage	<b>64,604</b>	59,487
Premium taxes	<b>38,434</b>	35,743
Other expense	<b>1,186</b>	4,264
Conversion expense	<b>5,583</b>	—
	<b>2,588,523</b>	2,403,125
Income before income taxes	<b>24,698</b>	62,689
Income tax expense	<b>6,780</b>	11,532
Net income	<b>\$ 17,918</b>	<b>\$ 51,157</b>

*See accompanying notes.*

# PREMERA

## Consolidated Statements of Comprehensive Income (In Thousands)

	<b>Year Ended December 31</b>	
	<b>2002</b>	<b>2001</b>
Net income	<b>\$17,918</b>	\$51,157
Other comprehensive income (loss), net of tax:		
Unrealized depreciation on available-for-sale investments (net of tax: 2002 – \$(959) and 2001 – \$(1,554))	<b>(3,836)</b>	(6,215)
Reclassification adjustment for net realized (gains) losses included in net income (net of tax: 2002 – \$5,779 and 2001 – \$(950))	<b>23,116</b>	(3,800)
Minimum pension liability adjustment (net of tax: \$(46))	<b>(184)</b>	–
Total other comprehensive income (loss)	<b>19,096</b>	(10,015)
Comprehensive income	<b>\$37,014</b>	\$41,142

*See accompanying notes.*

# PREMERA

## Consolidated Statements of Net Worth (In Thousands)

	<b>Year Ended December 31</b>	
	<b>2002</b>	<b>2001</b>
General reserves:		
Balance at beginning of year	<b>\$353,884</b>	\$302,727
Net income	<b>17,918</b>	51,157
Balance at end of year	<b>371,802</b>	353,884
Accumulated other comprehensive income (loss):		
Unrealized appreciation (depreciation) on available-for-sale investments, net of tax:		
Balance at beginning of year	<b>(1,966)</b>	8,049
Change in unrealized appreciation (depreciation) on available-for-sale investments	<b>19,280</b>	(10,015)
Minimum pension liability	<b>(184)</b>	—
Balance at end of year	<b>17,130</b>	(1,966)
Total net worth	<b>\$388,932</b>	\$351,918

*See accompanying notes.*

# PREMERA

## Consolidated Statements of Cash Flows (In Thousands)

	<b>Year Ended December 31</b>	
	<b>2002</b>	<b>2001</b>
<b>Operating activities</b>		
Net income	\$ 17,918	\$ 51,157
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized (gains) losses on sales of investments	35,067	(7,515)
Net realized losses on sales of property and equipment	380	3,251
Depreciation and amortization of property and equipment	11,718	7,394
Net amortization of premiums and discounts on investment securities	1,815	(430)
Deferred income taxes	(3,574)	(648)
Other	(931)	900
Changes in certain assets and liabilities:		
Deferred benefit trust	(2,609)	335
Accounts receivable, net	3,873	(1,418)
Investment income receivable	(569)	(623)
Federal income tax receivable	(173)	(350)
Prepaid expenses and deferred charges	(23,586)	(2,319)
Claims liability	9,685	44,043
Policy reserves	8,555	740
Unearned revenue	3,299	10,383
Accounts payable	(3,045)	19,827
Other liabilities	(983)	5,237
Total adjustments	38,922	78,807
Net cash provided by operating activities	56,840	129,964
<b>Investing activities</b>		
Proceeds from sales and maturities of available-for-sale investments	671,871	710,024
Purchases of available-for-sale investments	(744,673)	(755,511)
Purchases of property and equipment	(56,224)	(63,012)
Proceeds from sales of property and equipment	33,318	32,851
Net cash used in investing activities	(95,708)	(75,648)
Net increase (decrease) in cash and cash equivalents	(38,868)	54,316
Cash and cash equivalents at beginning of year	73,498	19,182
Cash and cash equivalents at end of year	\$ 34,630	\$ 73,498

*See accompanying notes.*

# PREMERA

## Notes to Consolidated Financial Statements

December 31, 2002

### 1. Nature of Operations and Significant Accounting Policies

#### Nature of Operations

PREMERA, a nonprofit holding company, is the sole voting member of Premera Blue Cross (PBC). PBC is a Washington State-domiciled nonprofit corporation, licensed as a health care service contractor. PBC is engaged in the business of providing basic medical, hospital, major medical, comprehensive, and other prepaid health care benefits for its subscribers in the states of Washington and Alaska.

PBC owns 100% of PremeraFirst, Inc., MSC Life Insurance Company (MSCL), and Washington-Alaska Group Services, Inc. (WAGS). PremeraFirst, Inc. is a Washington State corporation used primarily to act as an agent for contracting with physicians and providers. MSCL is a Washington State corporation authorized to transact the business of life and disability insurance. WAGS is a for-profit insurance agency, which, in turn, owns 100% of States West Life Insurance Company (SWL), LifeWise Health Plan of Oregon, Inc. (LWO) (formerly LifeWise, A PREMERA Health Plan, Inc.), LifeWise Health Plan of Washington (LWW) (formerly Premera LifeWise Health Plan, Inc.), Northstar Administrators, Inc. (NorthStar), and Quality Solutions (QS).

SWL, LWO, LWW, and NorthStar are for-profit organizations. SWL is domiciled in the state of Washington and underwrites group life, accident, disability, and medical contracts. LWO is domiciled in the state of Oregon and underwrites individual and group health insurance policies. LWO owns 100% of Western Benefits Administrators, a third-party administrator. LWW is a health care services contractor licensed in the state of Washington which primarily provides individual health insurance coverage to Washington State residents. NorthStar provides claims administrative services to self-funded plan sponsors. QS is a not-for-profit organization domiciled in the state of Washington and provides investigation and recovery services to health plans and self-funded employer benefit plans.

#### Conversion

In May 2002, the Board of Directors of PREMERA authorized management to commence discussions with state officials regarding the potential reorganizations (conversion) of PREMERA and PBC from nonprofit corporations to for-profit corporations. The plan of conversion requires the approval of the insurance commissioners in the states in which PBC and several of its affiliates are licensed. For the year ended December 31, 2002, PREMERA incurred \$5.6 million in costs relating to implementation of the conversion plan.

# PREMERA

## Notes to Consolidated Financial Statements (continued)

### 1. Nature of Operations and Significant Accounting Policies (continued)

#### Principles of Consolidation

The consolidated financial statements have been prepared using accounting principles generally accepted in the United States (GAAP) and include the accounts of PREMERA and PBC and subsidiaries (collectively hereinafter referred to as the Company). All significant intercompany balances and transactions have been eliminated in the consolidated financial statements.

#### Use of Estimates

Preparation of these consolidated financial statements requires management to make estimates and assumptions that affect amounts reported in the consolidated financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed herein.

#### Cash Equivalents

Cash and cash equivalents consist primarily of cash balances on hand and deposited in financial institutions, and all highly liquid investments with a maturity of 90 days or less when purchased.

#### Investments

The Company classifies its fixed income securities and marketable equity securities as available-for-sale. These securities are recorded at fair value with unrealized holding gains and losses, net of tax, recognized as a component of other comprehensive income. The fair values of investment securities are based on quoted market prices. For those securities where quoted market prices are not available, fair values are based on market prices of similar investments.

Premiums and discounts on fixed income securities are recognized as adjustments to investment income, using the scientific method, amortized over the period to maturity.

Interest on fixed income securities is recognized in income as accrued. The retrospective adjustment method is used to value all loan-backed securities.

Gain or loss on the sale of fixed income securities is determined using the amortized cost of the specific security sold. Gain or loss on the sale of marketable equity securities is determined using the average cost of all shares of that type of security held at the time of sale.

## PREMERA

### Notes to Consolidated Financial Statements (continued)

#### **1. Nature of Operations and Significant Accounting Policies (continued)**

Included with other investments are investments held for the benefit of PBC's supplemental retirement program. Investment values are stated at fair values, which are determined based on quoted market values.

The Company periodically evaluates whether the declines in fair value of its investments are other-than-temporary. This evaluation consists of a review of qualitative and quantitative factors. For investments with publicly quoted market prices, the Company generally considers a decline to be an other-than-temporary impairment if the quoted market price is less than its accounting basis for two quarters, absent evidence to the contrary. The Company also considers additional factors to determine whether the declines in fair value are other-than-temporary, such as downgrades of the security by a rating agency, any deterioration in the financial condition of the issuer, and other publicly available issuer-specific news or general market conditions. For investments in companies with no quoted market price, the Company considers similar qualitative and quantitative factors and also takes into account the cost of the investment, the type of investment, subsequent purchases of the same or similar investments by the Company or other investors, the current financial position and operating results of the company invested in, and such other factors as may be deemed relevant. Declines in fair values of securities deemed to be other-than-temporary are recognized as a reduction of net income.

Determining what constitutes an other-than-temporary decline involves significant judgment. Declines in fair value below cost not considered other-than-temporary in the current period could be considered other-than-temporary in a future period and reduce earnings to the extent of the write-down.

#### **Prepaid Expenses and Deferred Charges**

Costs incurred that provide economic benefit to the Company beyond the year in which they are expended are deferred and amortized on the straight-line method over the estimated useful life of the asset.

#### **Reinsurance**

The Company's reinsurance contracts primarily relate to SWL. Reinsurance premiums, claims, and claims processing expenses are accounted for on a basis consistent with those used in accounting for the original policies issued and the terms of the reinsurance contracts. Premiums and benefit expense and the related claims liability and unearned premium reserves are reported gross of reinsurance amounts.

# PREMERA

## Notes to Consolidated Financial Statements (continued)

### 1. Nature of Operations and Significant Accounting Policies (continued)

The Company remains obligated for amounts ceded in the event the reinsurers do not meet their obligations.

#### Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization are computed on the straight-line basis over the estimated useful lives of the assets, which range from 3 to 20 years.

#### Claims Liability

The claims liability represents the Company's best-estimated cost of settling claims relating to insured events that have occurred on or before the consolidated balance sheet date and are unpaid at year-end. The estimated liability includes the amount that will be required for future payments of claims that have been reported, claims related to insured events that have occurred but that have not been reported, and unpaid claims processing expense. Unpaid claims processing expense is an estimate of the costs to record, process, and adjust unpaid claims.

The claims liability is estimated using individual case-basis valuations and statistical analyses. These estimates are subject to the effects of trends in claims severity and frequency. Although considerable variability is inherent in such estimates, management believes that the claims liability is adequate. The estimates are continually reviewed and adjusted, as necessary, as experience develops or new information becomes known; such adjustments are included in current operations.

#### Revenue Recognition

Premiums are earned at contractual rates and are recorded as earned during the month subscriber coverage is provided. Premium revenues include health, life, and disability insurance products.

Administrative fee revenue includes revenue from certain administrative services group contracts (ASC) that provide for the group to be at risk for all, or with supplemental insurance arrangements, a portion of their claims experience. The Company charges self-funded groups an administrative fee which is based on the number of members in a group or the group's claim experience. Under the Company's self-funded arrangements, amounts due are recognized based on incurred claims paid plus administrative and other fees. In addition, administrative fee

# PREMERA

## Notes to Consolidated Financial Statements (continued)

### 1. Nature of Operations and Significant Accounting Policies (continued)

revenue includes amounts received for the administration of Medicare or certain other government programs. Administrative fees are recognized in accordance with the terms of the contractual relationship between the Company and the customer. Such fees are based on a percentage of the claim amounts processed or a combination of a fixed fee per claim plus a percentage of the claim amounts processed. All benefit payments under these programs are excluded from benefit expense.

#### **Federal Income Taxes**

PREMERA files as the common parent of an affiliated group. The liability method is used in accounting for income taxes. Accordingly, deferred tax assets and liabilities are recognized based on differences between the financial reporting and tax bases of assets and liabilities, and are measured using the enacted tax rates and laws expected to be in effect when the differences are anticipated to reverse, net of any applicable valuation allowances.

The effect on the deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that the change is enacted.

#### **Recent Accounting Standards**

Effective January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 144 (FAS 144), *Accounting for the Impairment or Disposal of Long-Lived Assets*. FAS 144 requires the recognition of an impairment loss if the carrying value of a long-lived asset to be held and used is not recoverable from its undiscounted future cash flows. FAS 144 also requires that a long-lived asset to be disposed of by sale be reported at the lower of its carrying amount or fair value less the costs to sell. The effect of adopting FAS 144 did not have an impact on the Company's consolidated results of operations or financial position.

#### **Reclassifications**

Certain prior year balances have been reclassified to conform to the current year presentation.

# PREMERA

## Notes to Consolidated Financial Statements (continued)

### 2. Investments

The cost or amortized cost, gross unrealized appreciation and depreciation, and estimated fair values of available-for-sale investment securities are as follows:

	<b>Cost or Amortized Cost</b>	<b>Gross Unrealized Appreciation</b>	<b>Gross Unrealized Depreciation</b>	<b>Estimated Fair Values</b>
<b>At December 31, 2002</b>	<i>(In Thousands)</i>			
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	\$133,391	\$ 6,714	\$ (60)	\$140,045
Corporate debt securities	220,756	11,410	(2,605)	229,561
Loan-backed securities	237,654	7,762	(181)	245,235
	<b>591,801</b>	<b>25,886</b>	<b>(2,846)</b>	<b>614,841</b>
Marketable equity securities	62,725	4,716	(6,114)	61,327
	<b>\$654,526</b>	<b>\$30,602</b>	<b>\$ (8,960)</b>	<b>\$676,168</b>
<b>At December 31, 2001</b>				
U.S. Treasury securities and obligations of U.S. Government corporations and agencies	\$ 98,538	\$ 610	\$ (780)	\$ 98,368
Corporate debt securities	199,096	4,577	(7,773)	195,900
Loan-backed securities	193,198	3,656	(846)	196,008
	<b>490,832</b>	<b>8,843</b>	<b>(9,399)</b>	<b>490,276</b>
Marketable equity securities	127,774	16,636	(18,530)	125,880
	<b>\$618,606</b>	<b>\$25,479</b>	<b>\$(27,929)</b>	<b>\$616,156</b>

# PREMERA

## Notes to Consolidated Financial Statements (continued)

### 2. Investments (continued)

The Company has pledged cash and eligible securities with an estimated market value of \$30.3 million at December 31, 2002 and \$65.2 million at December 31, 2001 to meet indemnity requirements of the State of Washington Office of Insurance Commissioner. Additionally, the above amounts include fixed income and marketable equity securities with a fair value of approximately \$14.7 million at December 31, 2002 and \$14.1 million at December 31, 2001, which were on deposit with various other regulatory authorities.

The cost or amortized cost and estimated fair values of available-for-sale fixed income securities at December 31, 2002, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	<b>Cost or Amortized Cost</b>	<b>Estimated Fair Values</b>
	<i>(In Thousands)</i>	
Due in one year or less	\$ 5,411	\$ 5,471
Due after one year through five years	139,177	144,431
Due after five years through ten years	102,946	107,782
Due after ten years	106,613	111,922
Loan-backed securities	237,654	245,235
	<b>\$591,801</b>	<b>\$614,841</b>

# PREMERA

## Notes to Consolidated Financial Statements (continued)

### 2. Investments (continued)

Proceeds from disposals of available-for-sale fixed income securities and marketable equity securities and related gross realized gains and losses on those disposals were as follows:

	<b>Year Ended December 31</b>	
	<b>2002</b>	<b>2001</b>
	<i>(In Thousands)</i>	
Proceeds from sales of fixed income securities	<b>\$499,519</b>	\$620,422
Proceeds from sales of marketable equity securities	<b>82,666</b>	43,249
Proceeds from maturities, redemptions, calls, and paydowns	<b>89,686</b>	46,353
	<b><u>\$671,871</u></b>	<u>\$710,024</u>
Sales of fixed income securities:		
Gross realized gains	<b>\$ 11,960</b>	\$ 16,430
Gross realized losses	<b>(9,926)</b>	(4,492)
	<b><u>2,034</u></b>	<u>11,938</u>
Sales of marketable equity securities:		
Gross realized gains	<b>8,236</b>	4,242
Gross realized losses	<b>(21,694)</b>	(8,665)
	<b><u>(13,458)</u></b>	<u>(4,423)</u>
Other-than-temporary decline in fair value of available-for-sale securities	<b>(23,643)</b>	—
Net realized (losses) gains on investments	<b><u>\$ (35,067)</u></b>	<u>\$ 7,515</u>

### 3. Fair Values of Financial Instruments

The following methods and assumptions were used by the Company in estimating the “fair value” disclosures for financial instruments in the accompanying consolidated financial statements and notes thereto:

*Cash and Cash Equivalents, Accounts Receivable, Other Investments, Accounts Payable, and Other Liabilities:* The carrying amounts reported in the accompanying consolidated balance sheets for these financial instruments approximate their fair values.

# PREMERA

## Notes to Consolidated Financial Statements (continued)

### 3. Fair Values of Financial Instruments (continued)

*Investment Securities:* The fair values of fixed income securities are based on quoted market prices, where available. For fixed income securities not actively traded, fair values are estimated using values obtained from independent pricing services or, in the case of private placements, are estimated by discounting expected future cash flows using a current market rate applicable to the yield, credit quality, and maturity of the investments. The fair values of marketable equity securities are based on quoted market prices. Fair values of investment securities are disclosed in Note 2.

All other financial instruments are specifically exempted from fair value disclosure requirements because they qualify as insurance-related products.

### 4. Property and Equipment

A summary of the cost and accumulated depreciation and amortization of property and equipment is set forth below:

	<b>December 31</b>	
	<b>2002</b>	<b>2001</b>
	<i>(In Thousands)</i>	
Land and land improvements	\$ 8,734	\$ 8,809
Buildings and improvements	53,676	50,195
Office and computer equipment	29,722	14,689
Software	14,588	12,316
	<b>106,720</b>	<b>86,009</b>
Less accumulated depreciation and amortization	<b>37,943</b>	<b>28,040</b>
	<b>\$ 68,777</b>	<b>\$57,969</b>

# PREMERA

## Notes to Consolidated Financial Statements (continued)

### 5. Claims Liability

Activity in the claims liability is summarized as follows:

	<b>2002</b>	<b>2001</b>
	<i>(In Thousands)</i>	
Unpaid claims liability at beginning of year	<b>\$ 327,020</b>	\$ 288,540
Add incurred claims related to:		
Current year	<b>2,188,895</b>	2,023,920
Prior years	<b>(49,757)</b>	(26,447)
Total incurred	<b>2,139,138</b>	1,997,473
Deduct paid claims related to:		
Current year	<b>(1,869,220)</b>	(1,708,731)
Prior years	<b>(265,863)</b>	(250,262)
Total paid	<b>(2,135,083)</b>	(1,958,993)
Unpaid claims liability at end of year	<b>331,075</b>	327,020
Life reserves	<b>7,055</b>	6,083
ASC-related reserves	<b>14,853</b>	11,433
Unpaid claims processing liability	<b>12,417</b>	11,179
Claims liability at end of year	<b>\$ 365,400</b>	\$ 355,715

As indicated in the foregoing reconciliation, the Company's claims liability at December 31, 2001 and 2000 was decreased by \$49.8 million and \$26.4 million, respectively, in the following year for claims that had occurred on or prior to those balance sheet dates. Those adjustments resulted primarily from the settlement of claims reported in prior years for amounts that were different than expected and were not related to a specific event or insured group. No return premiums were due as a result of the adjustments in the claims liability. Adjustments made to the claims liability for unpaid claims processing expense during 2002 and 2001 were immaterial.

The unpaid claims liability has been reduced by subrogation of \$15.3 million and \$12.4 million as of December 31, 2002 and 2001, respectively.

# PREMERA

## Notes to Consolidated Financial Statements (continued)

### 6. Reinsurance

The Company reinsures with other companies portions of the accident and health risks on certain policies it underwrites and services. Premiums and medical claims ceded under reinsurance contracts were as follows:

	<b>Year Ended December 31</b>	
	<b>2002</b>	<b>2001</b>
	<i>(In Thousands)</i>	
Premiums	<b>\$8,958</b>	\$7,059
Medical claims	<b>\$4,960</b>	\$2,310

As of December 31, 2002 and 2001, the Company had reinsurance recoverables of \$7.2 million and \$5.1 million, respectively, which have been reported in accounts receivable.

### 7. Federal and State Income Taxes

The provision for federal and state income tax expense consists of the following:

	<b>Year Ended December 31</b>	
	<b>2002</b>	<b>2001</b>
	<i>(In Thousands)</i>	
Federal income tax:		
Current	<b>\$9,303</b>	\$12,180
Deferred	<b>(3,574)</b>	(648)
	<b>5,729</b>	11,532
State income tax:		
Current	<b>1,051</b>	—
Total	<b>\$6,780</b>	\$11,532

# PREMERA

## Notes to Consolidated Financial Statements (continued)

### 7. Federal and State Income Taxes (continued)

The rate at which the Company provides for income taxes from the statutory federal rate is primarily due to the following:

	<b>December 31, 2002</b>	<b>Effective Tax Rate</b>	<b>December 31, 2001</b>	<b>Effective Tax Rate</b>
	<i>(In Thousands)</i>		<i>(In Thousands)</i>	
Provision computed at statutory rates	<b>\$ 8,644</b>	<b>35.0%</b>	\$21,941	35.0%
Permanent differences	<b>(10,160)</b>	<b>(41.1)</b>	(17,317)	(27.6)
Increase in valuation allowance	<b>7,837</b>	<b>31.7</b>	8,538	13.6
State income taxes	<b>1,051</b>	<b>4.3</b>	—	—
Other	<b>(592)</b>	<b>(2.4)</b>	(1,630)	(2.6)
Total	<b>\$ 6,780</b>	<b>27.5%</b>	\$11,532	18.4%

At December 31, 2002, the Company had net operating loss carryforwards of \$75.0 million available to offset future regular taxable income, if any, through the year 2018. Also, the Company had alternative minimum tax credit carryforwards of \$51.9 million available indefinitely to reduce regular federal income taxes. Income taxes of \$9.5 million and \$12.8 million were paid in 2002 and 2001, respectively.

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## Notes to Consolidated Financial Statements (continued)

### 7. Federal and State Income Taxes (continued)

Deferred federal income taxes consist of the following:

	<b>December 31</b>	
	<b>2002</b>	<b>2001</b>
	<i>(In Thousands)</i>	
Deferred tax assets:		
Net operating loss carryforwards	\$ 26,277	\$ 30,431
Minimum tax credit	51,856	42,960
Pension and deferred compensation	5,755	10,842
Post-retirement benefits	5,541	4,821
Claims liability	3,252	3,467
Impairment loss on available-for-sale investments	8,188	—
Other assets	13,807	9,062
Total deferred federal income tax assets	114,676	101,583
Less valuation allowance	89,177	84,509
Deferred federal income tax assets, net	25,499	17,074
Deferred tax liabilities:		
Other liabilities	(12,555)	(3,255)
Net deferred federal income tax assets	\$ 12,944	\$ 13,819

The Company establishes a valuation allowance for deferred tax assets when uncertainty exists with respect to future realization of the assets. The valuation allowance increased by \$4.7 million and \$6.4 million during 2002 and 2001, respectively.

Several of the prior years' consolidated federal income tax returns of the Company are either currently under examination or on appeals. In the opinion of management, adequate provision has been made at December 31, 2002 for income taxes that might be due as a result of these examinations.

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## Notes to Consolidated Financial Statements (continued)

### 8. Employee Benefits

#### *Defined Benefit Retirement Program/Pension Equity Plan*

The Company provides a pension equity plan covering substantially all of its employees and employees of its subsidiaries. The benefits are based on years of service and an employee's highest earnings, as defined, during consecutive plan years in the last 10 years of employment (excluding the plan year in which termination of employment occurs). The Company's funding policy is to contribute annually at least the minimum amount that is required by the Employee Retirement Income Security Act of 1974. Contributions are intended to provide for benefits attributed to service date, but also for those expected to be earned in the future.

The following summary sets forth the funded status of the Company's pension equity plan and amounts recognized at December 31:

	<b>2002</b>	<b>2001</b>
	<i>(In Thousands)</i>	
Change in benefit obligation:		
Benefit obligation at beginning of year	<b>\$ 76,719</b>	\$63,457
Service cost	<b>5,464</b>	4,329
Interest cost	<b>5,463</b>	5,075
Actuarial loss	<b>5,281</b>	8,848
Benefits paid	<b>(4,323)</b>	(4,990)
Benefit obligation at end of year	<b>88,604</b>	76,719
Change in plan assets:		
Fair value of plan assets at beginning of year	<b>58,695</b>	59,010
Actual return on plan assets	<b>(5,488)</b>	(1,139)
Employer contributions	<b>33,389</b>	5,814
Benefits paid	<b>(4,323)</b>	(4,990)
Fair value of plan assets at end of year	<b>82,273</b>	58,695
Underfunded status of the plan	<b>6,331</b>	18,024
Unrecognized net actuarial loss	<b>(30,634)</b>	(14,776)
Unrecognized transition obligation	<b>—</b>	241
Unrecognized prior service cost	<b>2,586</b>	2,935
(Prepaid) accrued pension cost included in prepaid expenses and deferred charges in 2002 and other liabilities in 2001	<b>\$(21,717)</b>	\$ 6,424

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## Notes to Consolidated Financial Statements (continued)

### 8. Employee Benefits (continued)

Net pension cost includes the following for the year ended December 31:

	<b>2002</b>	<b>2001</b>
	<i>(In Thousands)</i>	
Service expense	<b>\$5,464</b>	\$4,329
Interest expense	<b>5,463</b>	5,075
Return on assets	<b>(5,427)</b>	(4,937)
Net loss recognition	<b>339</b>	—
Prior service cost amortization	<b>(349)</b>	(349)
Transition obligation recognition	<b>(241)</b>	(301)
Net periodic pension cost	<b><u>\$5,249</u></b>	<b><u>\$3,817</u></b>

At December 31, 2002 and 2001, the weighted-average discount rate was 7.25% and 7.75%, respectively, and the expected long-term rate of return on plan assets was 8.50% for both years. At December 31, 2002 and 2001, the rate of increase in future compensation levels used in determining the actuarial present value of the projected benefit obligation ranged from 3.50% to 7.00%. Plan assets consist primarily of listed fixed income and marketable equity securities.

#### *Supplemental Defined Benefit Retirement Plan*

The Company has a nonqualified defined benefit retirement program covering executive management employees. Benefits under the defined benefit retirement program are based on the average compensation earned during the highest three years of the final five years of employment. Eligible employees are designated as participants by the Governance Committee of the Board of Directors. Employees become participants the first day of the pay period following the date they become eligible.

# PREMERA

## Notes to Consolidated Financial Statements (continued)

### 8. Employee Benefits (continued)

The following summary sets forth the funded status of the Company's supplemental defined benefit retirement plan and amounts recognized at December 31:

	2002	2001
	<i>(In Thousands)</i>	
Change in benefit obligation:		
Benefit obligation at beginning of year	\$3,048	\$2,442
Service cost	450	236
Interest cost	273	198
Amendments	666	—
Actuarial loss	256	344
Benefits paid	(186)	(172)
Benefit obligation at end of year	4,507	3,048
Fair value of plan assets	—	—
Underfunded status of the plan	4,507	3,048
Unrecognized net actuarial loss	(479)	(223)
Unrecognized prior service cost	(1,635)	(1,254)
Minimum pension liability	1,865	—
Accrued supplemental benefit cost included in other liabilities	\$4,258	\$1,571
Intangible asset included in prepaid expenses and deferred charges	\$1,635	\$ —

A minimum pension liability is required when the actuarial present value of accumulated benefits exceeds plan assets and accrued pension liabilities. The minimum pension liability adjustment, less an intangible asset, net of tax benefit, is reported as a component of comprehensive income, which was \$230,000 for the year ended December 31, 2002. The intangible asset related to the minimum pension liability in the amount of \$1,635,000 at December 31, 2002 is included in prepaid expenses and deferred charges. There was no minimum pension liability at December 31, 2001.

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## Notes to Consolidated Financial Statements (continued)

### 8. Employee Benefits (continued)

Net supplemental benefit cost includes the following for the year ended December 31:

	<b>2002</b>	<b>2001</b>
	<i>(In Thousands)</i>	
Service expense	<b>\$ 450</b>	\$236
Interest expense	<b>273</b>	198
Prior service cost amortization	<b>285</b>	212
Net supplemental defined benefit cost	<b><u>\$1,008</u></b>	<b><u>\$646</u></b>

At December 31, 2002 and 2001, the weighted-average discount rate was 7.25% and 7.75%, respectively. At December 31, 2002 and 2001, the rate of increase in future compensation levels used in determining the actuarial present value of the projected benefit obligation was 5.00%.

#### *Other Supplemental Retirement Programs*

The Company has a nonqualified defined contribution retirement program covering executive management employees. The Governance Committee of the Board of Directors approves eligible position titles. Certain positions are eligible for participation upon completion of one year of service and others are eligible following their first month in an eligible position. Benefits under the defined benefit retirement program are based on years of service and the participant's highest earnings during the term of service to the Company. The expense related to this program was \$1.7 million in 2002 and \$0.7 million in 2001.

The Company also has a deferred compensation plan for officers under which participation is voluntary.

The Company funds the deferred benefits of these programs through the establishment of a separate deferred benefit trust. The fair value of the trust assets, which have been included in other investments, was \$14.0 million and \$11.4 million at December 31, 2002 and 2001, respectively. Realized and unrealized gains and losses from the assets included in the trust accrue to the participants. However, participants only have an unsecured interest in trust assets. In the event of the Company's insolvency, trust assets can be used to satisfy the claims of general creditors. Deferred benefits relating to these programs were \$13.8 million and \$10.9 million at December 31, 2002 and 2001, respectively.

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## Notes to Consolidated Financial Statements (continued)

### 8. Employee Benefits (continued)

#### *Deferred Compensation Retirement Savings Plan*

The Company has a deferred compensation retirement savings plan, pursuant to Section 401(k) of the Internal Revenue Code, available to substantially all employees in the quarter following their date of hire. Participants may contribute up to 15% of their compensation, as defined by the plan, with the Company providing a matching contribution of the lesser of 50% of the participant's contribution or 3% of the participant's compensation, as defined. The Company made total contributions of approximately \$2.7 million and \$3.0 million to the plan in 2002 and 2001, respectively.

#### *Other Post-retirement Benefits*

The Company maintains a post-retirement benefit plan, which provides certain health care benefits for eligible retired employees. Substantially all employees may become eligible for these benefits if they reach retirement age while working for the Company. The cost of these benefits is shared by the Company and the retiree. The Company's policy is to fund the cost of these benefits in amounts determined at the discretion of management.

The following table reconciles the funded status of the post-retirement benefit plan and the amounts recognized in the Company's consolidated financial statements at December 31:

	<b>2002</b>	<b>2001</b>
	<i>(In Thousands)</i>	
Change in benefit obligation:		
Benefit obligation at beginning of year	<b>\$15,939</b>	\$13,341
Service cost	<b>697</b>	303
Interest cost	<b>1,648</b>	1,079
Amendments	<b>5,874</b>	—
Actuarial loss	<b>3,331</b>	1,892
Benefits paid	<b>(472)</b>	(676)
Benefit obligation at end of year	<b>27,017</b>	15,939
Fair value of plan assets	—	—
Underfunded status of the plan	<b>27,017</b>	15,939
Unrecognized net actuarial loss	<b>(5,414)</b>	(2,163)
Unrecognized prior service costs	<b>(5,455)</b>	—
Accrued pension cost included in other liabilities	<b>\$16,148</b>	\$13,776

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## Notes to Consolidated Financial Statements (continued)

### 8. Employee Benefits (continued)

The net periodic benefit cost includes the following for the years ended December 31:

	<b>2002</b>	<b>2001</b>
	<i>(In Thousands)</i>	
Service cost	<b>\$ 697</b>	\$ 303
Interest cost	<b>1,648</b>	1,079
Net loss recognition	<b>80</b>	—
Prior service cost amortization	<b>419</b>	—
Net periodic benefit cost	<b><u>\$2,844</u></b>	<b><u>\$1,382</u></b>

Actuarial assumptions used to determine costs and benefit obligations at December 31, 2002 and 2001 include discount rates of 7.25% and 7.75%, respectively, and health care cost trend rates of 12.0% for 2002 and 2001, decreasing to 5.5% after eight and nine years, respectively.

Assumed health care cost trend rates have a significant effect on the amounts reported for the nonpension post-retirement benefit plans. A 1% change in the assumed health care cost trend rates would have the following effects:

	<b>One Percentage Point</b>	
	<b>Increase</b>	<b>Decrease</b>
	<i>(In Thousands)</i>	
Effect on total service and interest cost components	\$ 506	\$ (385)
Effect on post-retirement benefit obligations	4,775	(3,763)

### 9. Physicians' Deferred Compensation Plan

The Company maintained a nonqualified deferred compensation plan for participating physicians. The plan allowed for reductions of the physicians' earnings prior to 1994 and included an unsecured contractual promise to pay specified amounts at the occurrence of specific events. The Company recorded an asset for funds invested in a group, flexible premium insurance contract, and insurance annuity contracts with Mutual Benefit Life Insurance Company, and a corresponding liability for payment of estimated amounts to both retired and active physicians participating in the plan.

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### Notes to Consolidated Financial Statements (continued)

#### 10. Leases

The Company has entered into six sales and leaseback agreements, primarily for certain of its computer software, computer equipment, furniture, fixtures, and other equipment. Four of the operating leases are initially 18-month leases with renewal available on a year-to-year basis for two one-year renewal terms. The remaining two operating leases are initially 48-month leases with renewal available for 48 months. No gains or losses were recorded regarding the transactions. Certain of these leases contain guarantees of the residual value of the leased assets. As of December 31, 2002, the value of these guarantees is approximately \$1.4 million.

The Company's rental expense for 2002 and 2001 was \$21.2 million and \$15.6 million, respectively. The principal leases, all of which are operating leases, are for data processing equipment, office equipment, and office space. The leases contain various provisions for renewal options, sublease agreements, and lease cancellations with nominal penalties.

Future minimum lease payments under noncancelable operating leases at December 31, 2002 are as follows (in thousands):

<u>Year Ending December 31</u>	<u>Sale/ Leaseback Agreements</u>	<u>Other Lease Agreements</u>	<u>Total</u>
2003	\$18,934	\$4,686	\$23,620
2004	18,577	3,882	22,459
2005	15,405	2,890	18,295
2006	7,935	2,102	10,037
2007	—	1,339	1,339
Thereafter	—	5,030	5,030

#### 11. Commitments and Contingencies

PBC has provided a guarantee that it will provide capital in the amount necessary to maintain a specified minimum ratio of admitted assets to liabilities for SWL. The cumulative obligation under the agreement is not to exceed \$5 million.

Various lawsuits against the Company have arisen in the course of the Company's business. Potential contingent liabilities arising from litigation, income taxes, and other matters are not considered material in relation to the consolidated financial position or results of operations of the Company.

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### Notes to Consolidated Financial Statements (continued)

#### 12. Agency Contracts

PBC acts as a fiscal intermediary and subcontractor in administering certain health care programs, including Medicare. Claim payments processed by PBC for Medicare, which are not included in the consolidated financial statements, were \$1.7 billion and \$1.5 billion for 2002 and 2001, respectively. Revenue resulting from administering these programs was \$8.6 million and \$8.0 million for 2002 and 2001, respectively. The revenue received from the Medicare program is subject to final federal government approval, and any resulting adjustments are recognized in current operations.

Medicare regulations require PBC to use the checks-paid method for the Medicare bank account. Under this method, the bank holds an irrevocable letter of credit from the U.S. Department of Health and Human Services and draws funds to cover Medicare program checks as they are presented for payment. This method of payment resulted in technical overdrafts of \$18.4 million and \$4.9 million at December 31, 2002 and 2001, respectively. The technical overdrafts for Medicare are netted against the corresponding receivables, which represent claim payments made by PBC on the program's behalf.

The net reimbursement for administrative expenses was less than actual expenses incurred for Medicare contracts by \$1.8 million in 2002 and \$.2 million in 2001.

#### 13. Statutory Reserves and Net Income

PBC, MSCL, LWO, SWL, and LWW (the Companies) file regulatory reports and financial statements with various state insurance commissioners in accordance with statutory accounting practices prescribed or permitted by the respective domiciliary state insurance department. Prescribed statutory accounting practices include a variety of publications of the National Association of Insurance Commissioners (the NAIC), as well as state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed. The Companies have no significant permitted statutory accounting practices.

Effective January 1, 2001, the domiciliary states of the Companies adopted the provisions of the NAIC *Accounting Practices and Procedures* manual. The NAIC *Accounting Practices and Procedures* manual changed, to some extent, prescribed statutory accounting practices and resulted in changes to the accounting practices that the Companies use to prepare their statutory-basis financial statements. The cumulative effect of changes in accounting principles adopted to conform to the NAIC *Accounting Practices and Procedures* manual has been reported as an

## PREMERA

### Notes to Consolidated Financial Statements (continued)

#### 13. Statutory Reserves and Net Income (continued)

adjustment to statutory reserves/unassigned surplus as of January 1, 2001. The effect of adoption did not result in a significant reduction in the Companies' statutory-basis capital and surplus as of January 1, 2001.

Differences between statutory reserves/unassigned surplus and statutory net income and net worth and net income as determined on a GAAP-basis primarily relate to differences in accounting for net income of subsidiaries, unrealized gain or loss on available-for-sale fixed income securities, post-retirement benefits, and nonadmitted assets, such as prepaid expenses and certain furniture, equipment, and software.

A summary of PBC's statutory reserves/unassigned surplus and statutory net income at December 31 is as follows:

	<b>2002</b>	<b>2001</b>
	<i>(In Thousands)</i>	
Statutory reserves/unassigned surplus	<b>\$311,613</b>	\$328,280
Statutory net income	<b>7,525</b>	38,505